Directorate of Intelligence

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International Economic & Energy Weekly

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Indicators

Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] 25X1

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International Economic & Energy Weekly [redacted] 25X1

Synopsis

Perspective—*South American Debt: The Risk of Misunderstandings* [redacted] 25X1

The focus of attention among bankers and in the press is shifting to the South American countries. We are concerned that there remains significant risk of missteps and miscalculation in the coming months. [redacted] 25X1

Brazil: Critical IMF Negotiations [redacted] 25X1

Brazil's financial rescue package, hastily put together by the IMF and foreign banks in December, has stalled. Although we believe Brazil will ultimately reconcile differences with the IMF, the negotiations will be difficult. If a new agreement cannot be worked out soon, Brazil will have little choice but to declare at least a temporary moratorium on its debt servicing. [redacted] 25X1

Venezuela: Stumbling Through Debt Talks [redacted] 25X1

Venezuela, once one of Latin America's most attractive borrowers, has been in serious financial straits for over a year. We believe the Herrera government will seek to delay signing a refinancing agreement requiring IMF austerity until after the December presidential elections. [redacted] 25X1

Argentina: Difficulties With the IMF Ahead [redacted] 25X1

Argentina has for now halted its economic slide as the current economic team reversed the populist policies of its predecessors and managed to sign an agreement with the IMF. We expect Argentina will have difficulty complying with IMF targets as fiscal discipline is relaxed on the road to elections in late October. [redacted] 25X1

Andean Countries: Grappling With Payments Problems [redacted] 25X1

Since January, cutbacks in private bank lending and weak export performance have caused severe financal strains throughout the Andean region. Adjustments are now under way to relieve these financial stringencies, but difficulties persist. [redacted] 25X1

Latin America: Prospects for Collective Action on Debt [redacted] 25X1

Latin American debtors have periodically raised the specter of collective action to ease the burden of their debt service. Although there is no evidence that the leadership of any of the large debtor countries is presently considering such a radical move, the possibilities for joint action by Latin American debtors to obtain better repayment terms are being more widely discussed. Joint action would become far more attractive to the debtors if IMF-sponsored refinancing programs should falter. [redacted] 25X1

The Philippines: Growing Financial Strains [redacted] 25X1

Manila is attempting to avert a liquidity crisis that could force foreign debt rescheduling by late 1983. [redacted] data on the size of the short-term foreign debt, combined with a slow contraction of short-term credit lines by private commercial banks, suggest that the government has little room to maneuver. [redacted] 25X1

[redacted] 25X1

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Perspective

South American Debt: The Risk of Misunderstandings [redacted] 25X1

With the Mexican debt situation seemingly under control, the focus of attention among bankers and in the press is shifting to the South American countries, which together account for $55 billion of active US loans. The frenetic pace of negotiations and the flurry of public announcements leave the clear impression that "something" will be worked out in each case. Indeed, the more optimistic observers point out that world economic recovery, now under way, will soon make Latin debt yesterday's problem. [redacted] 25X1

We are concerned, however, that there remains significant risk of missteps and miscalculations. We—and other observers—are unable to predict how bankers and debtors will react to the problems which still lie ahead. [redacted] 25X1

Already South American debtors are encountering difficulty with their IMF agreements. In January, Chile acknowledged it was unable to meet IMF monetary and foreign reserve targets; it is now operating under a revised "shadow program." Brazil was denied more than $1 billion in loan payments at the end of May because it was out of compliance with most of its performance targets. [redacted] 25X1 25X1

Numerous problems are plaguing the stabilization programs that are the keystone of the current LDC financial rescue effort. The pace of economic recovery in the OECD has not been rapid enough to support programed growth in South American exports. Prices for the region's key export commodities are firming, but are still below levels prevailing in 1980. Moreover, the failure of bankers to meet their lending commitments to the IMF programs has jeopardized the ability of some borrowers—notably Brazil—to meet their financial targets. Additionally, the debtors are finding it difficult to actually implement agreed upon economic reforms because of institutional constraints within their own governments. [redacted] 25X1

International cooperation will be likely to avert the default of a major South American borrower, but the difficulties with the IMF auger continued stress for world financial markets. Although we judge that the IMF will allow a fair amount of flexibility in administering the programs, temporary funding gaps are likely as the parties negotiate midcourse corrections. With borrowings temporarily cut, however, South American countries will have little choice but to resort to commercial arrearages or payments suspensions to relieve financial stringencies. At this juncture, we do not know how the commercial banks will respond to continued disruptions to their debt repayments. [redacted] 25X1

The clearest present danger is that Brasilia will declare a moratorium on its payments. At best, a decision to halt temporarily loan repayments—excluding interest—would enable Brasilia to obtain some financial breathing room, although at the cost of disrupting its short-term financing flows. Most bankers judge—and we agree—that a temporary standstill on repayments would not prove permanently damaging to Brazil's creditworthiness. In a worst case, however, numerous bankers foresee that Brasilia would suspend all debt payments and freeze foreign exchange deposits. They fear that such a move would be followed by other South American debtors, thereby causing creditors to halt trade financing and withdraw interbank deposits. Under such conditions, the various rescue programs would collapse, and South America's difficulties would probably spill over to other Third World borrowers. [redacted] 25X1

Over the near term, we anticipate growing South American political difficulties that will compound the situation. Tough economic retrenchments have already caused rising unemployment and lower living standards throughout the region. Protests against IMF-mandated austerity have erupted in Argentina, Brazil, Chile, and Peru. We believe continued austerity and record inflation will further lower living standards. South American political leaders will face tough choices between policies to maintain austerity and those that would be more conducive to near-term political stability. [redacted] 25X1

Faced with these tradeoffs, we believe Latin leaders are likely to backslide on their IMF commitments in an effort to ensure domestic tranquillity. Moreover, political leaders are likely to resist taking the tougher steps demanded by bankers because they could spark social unrest. Brazil is already moving in this direction. In its latest adjustment program, announced on 9 June, Brasilia refused to make a major overhaul of its indexation system because it feared the social consequences. [redacted] Brazilian President Figueiredo is now giving increased authority for economic decision making to his principal political adviser. We believe this means that political considerations will play an even greater role in setting future economic policies. [redacted] 25X1

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[redacted] 25X1

Briefs

Energy

Coal Boom Falters

Rapid growth in international coal trade came to an abrupt end last year. After jumping from 229 million tons in 1979 to 271 million tons in 1981, world coal imports virtually stagnated in 1982 because of the world recession and inventory adjustments. We expect trade to decline this year. Reductions in stocks will continue to have a negative impact on coal imports, particularly in Japan and Western Europe. In addition, the fall in oil prices is beginning to slow the speed of coal conversions. Depending on the strength of the economic recovery, world coal imports will likely range between 244 million and 269 million tons, according to industry estimates. As the high cost supplier, the United States will bear the brunt of the fall-off in demand, with forecasters predicting a 25- to 30-percent decline in exports from the 1982 level of 95 million tons. Last year US coal exports reached $6 billion and provided over 50,000 jobs in the coal-mining industry. 25X1

World Coal Imports *Million tons*

	1979	1981	1982 [a]	1983 [b]
Total	**228.8**	**271.1**	**273.4**	**244-269**
Western Europe	97.5	115.0	106.9	91-101
Japan	57.9	78.4	79.1	70-75
North America	19.5	17.5	18.4	16-18
Latin America	6.3	4.7	5.7	5-7
Eastern Europe	32.5	30.6	35.0	33-37
Other	15.1	24.9	28.4	29-31

[a] Preliminary.
[b] Estimated.

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Phillips Abandons Ekofisk Waterflood Project

Lower world oil prices and investment costs estimated at $1.7-2.1 billion have led the Phillips Petroleum group to abandon plans for a full-scale waterflood project at Norway's Ekofisk field. The project would have allowed recovery of an additional 190-220 million barrels of oil over a 10- to 20-year period.

According to the Phillips group, the project is uneconomic, given the current tax structure. The Norwegian Oil Ministry remains strongly in favor of the project and is expected to respond to the reported pullout later this month. Tax concessions would alter Phillips' evaluation, but any tax changes would require approval of the Norwegian legislature. In order to yield optimal results the waterflood project should get under way this year. [redacted] 25X1

Indonesia and Caltex Negotiate Production Agreement

[redacted] Pertamina—Indonesia's state oil company—may ease its demands for a production-sharing agreement with Caltex later this year. An 85:15 production split in favor of the government currently applies to all production-sharing arrangements, but Pertamina reportedly suggested a 95:5 split for output above 250,000 b/d. Caltex—a consortium of Texaco and Standard Oil of California—currently produces nearly half of Indonesia's total output of 1.3 million b/d and has offered Pertamina an 86.5:13.5 production-sharing formula. [redacted] 25X1

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International Finance

Mexico Reschedules Officially Guaranteed Private-Sector Debt

Mexico City announced last week that it had reached agreement with 16 creditor nations to reschedule nearly $2 billion in officially guaranteed loans to private-sector borrowers. The agreement reschedules medium- and long-term principal and interest unpaid as of 30 June and principal payments due during July through December 1983 over six years with a three-year grace period. Arrearages on short-term debt will be paid in four installments beginning in September 1983 and ending in June 1986. Short-term credits coming due after 30 June will be paid on schedule. Principal payments due in 1984 will be rescheduled on similar terms at the end of 1983 [redacted] 25X1

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Under the agreement the private sector will make payments in pesos to one of two designated government banks, and the exchange risk will be assumed by FICORCA, a government agency established to assist the private sector by guaranteeing foreign exchange at a future date. Commercial risk, however, will remain with the creditor, as Mexico City successfully fended off requests from several creditors that it assume the debt in the event of a private company default. We believe that this agreement may pave the way for the release of new trade credits promised earlier this year by foreign governments. [redacted] 25X1

Progress in rescheduling nonguaranteed private-sector debt has been minimal. The US Embassy estimates that only $200 million of the $9 billion under renegotiation had been rescheduled under terms laid out by Mexico City in

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April. [redacted] many Mexican businessmen doubt Mexico City's ability to deliver foreign exchange as promised. They cite earlier inability of financial officials to provide the foreign exchange that the government had guaranteed in an earlier scheme last fall. According to Embassy reporting, Mexican financial officials plan to offer a series of seminars to US bankers this month to explain the rescheduling scheme for private-sector debt and to encourage bankers' participation. [redacted] 25X1

Mexico To Cut Food Subsidies

Mexico City doubled the price of bread and raised tortilla prices 41 percent on Tuesday. Even so, Mexican officials indicate that corn and wheat subsidies will still cost $500 million during the remainder of the year. To maintain essential food supplies through September, Mexican financial and agricultural officials project they need $500 million more in food imports. Because drought and low farm support prices slashed grain output last year, Mexico already greatly increased food imports, mostly by drawing all the $1.2 billion credit for this fiscal year from the US Commodity Credit Corporation. Public reaction so far has been subdued. Price increases were expected with the expiration of the six-month price freeze on food staples and public transportation that was part of the wage settlement last December. No increases were announced for bus, subway, or rail fares. [redacted] 25X1

The decision demonstrates President de la Madrid's willingness to take tough steps to stay in compliance with the IMF program. Additional moves such as large cutbacks in public employment are slated for Mexico to meet budget targets. Nevertheless, plunging economic activity, near triple-digit inflation, and falling consumption are causing a small but growing division among decisionmakers over whether Mexico should continue biting the bullet. [redacted] 25X1

[redacted] 25X1

Global and Regional Developments

European Community Revises GNP Forecast

The EC Commission recently revised its member forecasts for 1983 GNP. Commission expectations for the EC economies as a group have changed little—0.5-percent growth as a group compared to 0.4 percent in the earlier forecast—because greater expectations for growth in West Germany, the United Kingdom, Italy, and Denmark offset a worsened outlook for the other EC members. West German and British growth prospects have improved the most, based primarily on an expected pickup in consumer demand and industrial orders. The sharpest downward revisions have occurred in France and Ireland, where new austerity programs have been adopted. Commission economists are warning, however, that their present forecast may be too optimistic if the recent uptick in US interest rates pushes up West European rates. [redacted]

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European Community: EC Commission GNP Growth Forecasts, 1983 *Percent*

	Early 1983	Mid-1983
European Community	**0.4**	**0.5**
West Germany	−0.2	0.7
France	0.8	−0.8
United Kingdom	1.5	2.4
Italy	−0.3	NEGL
Belgium	−0.4	−1.0
Denmark	0.9	1.2
Greece	1.1	0.5
Ireland	1.5	0.5
Luxembourg	−1.1	−1.4
Netherlands	0.1	−0.2

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The Commission probably is too bearish on the EC economies. Industrial production and unemployment data suggest that the EC economies bottomed out earlier this year, and we believe that growth will advance almost 1 percent for the year as a whole. Moreover, if the US economy expands more rapidly than the 2 to 3 percent expected by the Commission—as seems likely—EC countries would benefit from increased exports to the United States. 25X1

EC Steel Cutbacks Ordered

The EC Commission on Thursday ordered large cutbacks in EC steelmaking capacity but postponed determining how these reductions will be implemented. For the Community as a whole, the Commission is requiring by 1985 a 15.8-percent reduction in capacity—26.7 million tons—from the level of 1980. Member governments now have until 31 January 1984 to submit national plans to carry out the Commission's mandatory cutbacks. Commission officials acknowledge that the reductions will add at least another 150,000 to the 250,000 steelworkers already unemployed and have called on the EC to approve emergency social programs. 25X1

The required reductions in capacity will lead to a major test of the Commission's ability to regulate the EC steel industry. Although West Germany, France, and the United Kingdom already are planning cutbacks close to those ordered by the Commission, Italy and the Benelux countries will need to shut

European Community: Cutbacks in Steel Production Capacity by 1985

	1980 Capacity (*million tons*)	Governments' Proposed Reductions (*percent*)	EC Commission Ordered Cutbacks (*percent*)
Total [a]	**168.3**	**10.9**	**15.8**
West Germany	53.1	9.0	11.3
Italy	36.0	6.5	16.1
France	26.9	17.4	19.7
United Kingdom	22.8	17.5	19.7
Belgium	16.0	10.6	19.4
Netherlands	7.4	3.5	13.0
Luxembourg	5.2	10.8	18.4
Denmark	0.9	NA	7.0

[a] Excluding Greece and Ireland. Both are exempt from the cutbacks because their steel industries are very small.

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down more plants than planned. Indeed, the caretaker Italian Government has already rejected Commission requirements. Failure to comply could lead to fines and withholding of EC aid for restructuring programs. 25X1

UNCTAD VI Concludes

UNCTAD VI, which concluded last week, failed to produce agreement between industrial and developing countries on trade, monetary reform, and commodity price stabilization but nonetheless managed to forestall a breakdown in the North-South dialogue. The developing countries are skeptical that the international economic recovery will include them, and consequently they refused to significantly reduce their demands. The industrial nations turned back Third World proposals for massive resource transfers, structural reform of international economic institutions, and an international monetary conference. The United States, however, was isolated in its opposition to resolutions permitting UNCTAD to examine the IMF's Compensatory Financing Facility and to continue work on trade in services. The meeting's most important result probably was the impetus it gave to ratification of the Common Fund. Enough countries now appear ready to join the Fund so that its entry into force will hinge on US ratification 25X1

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Big Seven Trade Deficit With OPEC Narrows

The Big Seven trade deficit with OPEC fell to an estimated $8 billion in the first quarter as a result of a further drop in oil imports. The United States reported the largest trade improvement despite the continuation of the export declines to OPEC that began in second-quarter 1982. The Big Seven reported improved trade balances with most OPEC members. Their largest trade gains were with Saudi Arabia and Libya; Big Seven deficits with three financially troubled oil producers—Ecuador, Indonesia, and Venezuela—widened in the first quarter as these countries curbed their purchases from the industrial West. A further reduction in the Big Seven trade deficit with OPEC is likely in the second quarter as a result of soft oil prices. [redacted] 25X1

Big Seven: Trade Balances with OPEC Countries [a] *Billion US $*

	1981	1982					1983 1st Qtr
		Total	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	
Big Seven	**−80.9**	**−45.4**	**−14.1**	**−8.3**	**−12.9**	**−9.6**	**−8.0**
United States	−30.3	−9.9	−4.0	−1.1	−3.4	−1.4	−0.4
Japan	−32.0	−26.7	−7.9	−5.9	−6.4	−6.3	−6.1
West Germany	−1.2	2.2	1.0	0.8	0.5	0	0.7
France	−11.4	−8.2	−2.0	−2.0	−2.3	−1.9	−1.6
United Kingdom	3.8	4.5	1.2	1.3	0.7	1.3	1.2
Italy	−6.7	−6.7	−2.0	−1.4	−1.9	−1.4	−1.7
Canada	−3.1	−0.6	−0.4	0	−0.1	0.1	−0.1

[a] Quarterly trade balances were computed on the basis of seasonally adjusted exports and imports. First-quarter 1983 figures include March estimates for France, the United Kingdom, Italy, and Canada.

[redacted] 25X1

Libyan-Italian Commercial Payment Problems Mount

Tripoli is again as much as $750 million in arrears to Italian firms, [redacted] 25X1
[redacted] The payments slowdown probably is an attempt 25X1
by Qadhafi to extract trade concessions from Rome such as larger purchases of Libyan petroleum. The regime successfully used its overdue payments position with other suppliers last year to sharply increase sales of Libyan oil to help resolve more than $6 billion in commercial payment obligations. Italy was part of last year's deals and received $300 million and a sizable increase in

deliveries of low cost oil. We doubt the Italians will publicly criticize the Libyans because of Rome's substantial interest in developing Libya's offshore oil resources. Rome may delay the completion of some petroleum projects in Libya, however, if the arrearage problem is not redressed. [redacted]

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Cuba-Ecuador Aid Offer

Cuba is continuing to urge Ecuador to accept development assistance. Last month Cuban officials offered economic aid to an unofficial Ecuadorean delegation led by a university director and a Communist Party secretary. [redacted] 25X1

[redacted] In January Ecuador accepted free Cuban medical supplies for flood victims but turned down Havana's offer of medical personnel. Quito has spurned similar overtures in the past, and the signing of a formal aid agreement is unlikely. The latest offer may involve public health assistance, including the construction of a hospital. [redacted] 25X1

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Libya-Ghana Oil Credit Denied

Libya has decided not to provide Ghana with a $350 million oil credit that would cover Accra's oil import needs for a year. The US Embassy reports Ghana's oil situation is critical, with only enough stocks on hand to meet normal consumption through the end of this month. Ghana has approached Nigeria for assistance, but Lagos is withholding shipments until the Ghanaians pay at least $20 million for past deliveries. [redacted] 25X1

Libyan leader Qadhafi may have killed the oil deal to underscore his disapproval of Ghana's tentative overtures toward the West. Earlier this year Accra agreed to longstanding demands by the United States and other Western donors to seek help from the IMF. Collapse of the oil deal, however, removes a key feature of a proposed agreement with the IMF that could provide Ghana with $260 million in foreign exchange. To encourage Libya to reverse its decision, Ghana may resume its anti-US rhetoric. [redacted]

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National Developments

Developed Countries

Japanese Export Drive

A new Japanese export drive is probably under way. In May exports rose 0.5 percent from the year-earlier level, the first such gain in 16 months. Foreign orders for machinery, which account for one-fourth of Japanese overseas sales, also increased. More important, export letters of credit—a reliable indicator of future trade trends—have been on the upswing for three months. [redacted] 25X1

Although Japan's Economic Planning Agency points to reductions in exporters' overseas inventories and the US economic recovery for the turnaround, the upturn in exports has yet to hit the United States. Japan's overall trade surplus on a customs clearance basis in the first five months of 1983 was $5.3 billion above the year-earlier level, but Japan's surplus with the United States was only $600 million higher. Much of the increase in Japan's global trade surplus reflects lower oil prices. The bulk of the improvement for the remainder of the year will most likely come on the export side. [redacted] 25X1

Japanese Auto Export Policy

The recent statement by Trade Minister Uno rejecting an extension of the current restraints on auto exports to the United States may not be Tokyo's final position. Other Japanese officials have said that Uno's statement did not reflect a change in policy. The US Embassy believes Uno probably tailored his remarks to his audience—a group of Japanese automobile manufacturers. [redacted] Japanese officials are increasingly concerned 25X1 about the mounting trade surplus and are particularly worried that relations with Washington will deteriorate as the US elections get closer. The current agreement runs through March 1984, and the Japanese Government probably has not yet ruled out another agreement. Uno's comment may reflect an attempt to stake out an initial negotiating position. Similar statements were made by the previous trade minister before the current agreement was reached. [redacted] 25X1

Australian Wage Freeze Extended

The National Arbitration Commission's extension last week of Australia's six-month wage freeze signals a temporary victory for Prime Minister Hawke, who has argued that wage restraint is the crucial factor in Australia's economic recovery. Canberra had been under pressure from militant trade unions to reestablish wage indexation in June; last April's domestic economic summit of business and labor leaders supported its resumption. The Commission will now tackle the job of reforming Australia's wage indexing system, which it expects to complete by September. [redacted] 25X1

Communist

Soviet Concern Over Low Birth Rate

Soviet demographers have become skeptical that measures adopted in 1981 to stimulate the birth rate will prove effective. These measures included one-year partially paid maternity leave and lump-sum grants for first, second, and third births. The demographers are now convinced that these financial incentives are too low—one explicitly admitted this to an Embassy officer recently—and must be supplemented by other steps. They seem doubtful, however, that even a much more ambitious pronatal program will reverse unfavorable demographic trends. The Soviet birth rate has been declining for several years—from 24.9 births per 1,000 population in 1960 to 18.5 in 1981. [redacted] 25X1

Brazil: Critical IMF Negotiations [redacted] 25X1

Brazil's financial rescue package, hastily put together by the IMF and foreign banks in December, has stalled. Since April, the liquidity position has weakened considerably because of shortfalls in export earnings and the failure of foreign banks to provide expected amounts of short-term financing, thus forcing a run up of arrears. Brazil's cash-flow problem grew acute in June when more than $1 billion in IMF and foreign bank loan disbursements due to Brazil on 31 May were postponed because Brazil failed to meet the terms of its agreement with the IMF. To deal with this unanticipated foreign exchange deficiency, Brasilia is resorting so far to stopgap measures until it is able to resolve its differences with the IMF. [redacted]

Although we believe Brazil will ultimately reconcile differences with the IMF, the negotiations will be difficult. The IMF, supported by foreign creditor banks, is insisting that Brasilia adopt much tougher austerity measures than those implemented thus far. President Figueiredo, however, wants to avoid harsh steps that could provoke social unrest during the ongoing process of political liberalization. If a new agreement cannot be worked out soon, Brazil will have little choice but to declare at least a temporary moratorium on its debt servicing. [redacted]

Problems With the IMF

Brazil's IMF stabilization program was in trouble almost from the beginning because of unrealistic goals, the unwillingness of banks to fulfill financial pledges, and a lack of government aggressiveness in pushing austerity. By February, it became obvious that Brazil's current account deficit could not be squeezed even close to the $7 billion goal because of the slow world recovery and overvalued cruzeiro. To get the program back on track, the government carried out a large cruzeiro devaluation that month. This action boosted exports but fueled inflationary pressures. Accelerating inflation—to well over 100 percent—automatically pushed public-sector spending higher via the indexation system, eroding Brazil's ability to stay within IMF limits. Meanwhile, the reluctance of West European and US regional banks to restore interbank credit lines was largely to blame for Brazil's international reserve deterioration and an accumulation of payments arrearages. [redacted] 25X1

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Brasilia subsequently demonstrated reluctance to tighten fiscal and monetary policies to deal with resurgent inflation. In early May, the IMF suspected that Brazil had fallen appreciably short on its commitments. Later in the month, a technical team found that Brasilia failed to meet major first-quarter performance targets—particularly public-sector spending and borrowing, domestic credit, and international reserves. On the basis of its findings, the IMF judged that Brazil did not qualify for a second loan installment scheduled for the end of the month. [redacted] 25X1

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The IMF's decision to suspend further loan payments to Brazil intensified the country's cash-flow problem. Not only did the Fund defer payment of its $410 million installment but foreign banks postponed a planned 1 June transfer of $640 million in medium-term commercial loans tied to the IMF agreement. Brazil has been able temporarily to absorb this loss of funds by rolling over payments on bridge loans due to the Bank for International Settlements and other banks. [redacted]

Since May, banker confidence in Brazil's ability and determination to manage its economy has dwindled. This has led to some erosion in short-term financing support. [redacted] many banks have recently reduced the volume of trade credits they are willing to extend, and foreign banks have withdrawn some $300 million in interbank deposits in recent weeks. [redacted]

Renegotiations Under Way

With its loans cut, Brasilia recognized the need to implement some midcourse corrections. In preparation for an impending visit by an IMF negotiating team, the government's National Monetary Council on 9 June announced part of a new austerity package designed to raise government revenues and reduce public-sector spending. Among the measures disclosed were trimmed subsidies for agriculture and exports, higher prices for petroleum products, and increased taxes in the financial sector. The package, however, omitted Planning Minister Delfim's proposals for heavy cuts in state enterprise budgets and changes in Brazil's wage and price indexation system. [redacted]

Since arriving in Brazil on 11 June, the IMF team has stressed that Brazil must take stronger steps. Particularly, the Brazilian Government has been urged to slash public-sector spending. The team is also pressing for deindexing wages. [redacted]

Some progress has been made in the talks. Brasilia reportedly pledged a quicker phaseout of subsidies for wheat and sugar. The government cut public enterprise investment and made some cuts in public employee benefits and cost-of-living adjustments. 25X1

[redacted] 25X1

While the IMF talks have proceeded, a new 14-member bank advisory committee has been laying the groundwork for steps to overcome Brazil's growing financial problems. [redacted] Brazil's major creditors have indicated that they probably will arrange a new $3 billion medium-term commercial loan to see the country through the end of 1983. A loan of this size, [redacted] would compensate Brazil for shortfalls both in interbank deposits and in export earnings. The committee reportedly is prepared to begin consideration of Brazil's 1984 financing and debt rescheduling needs. The bankers stress, however, that concrete actions must await IMF approval of a new Brazilian austerity program. [redacted]

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Obstacles to Settlement

We believe major differences between Brazil and the IMF remain:

- The announced public spending cuts appear inadequate for Brazil to reach its public deficit target under the original IMF agreement. Recent large protest demonstrations and strike threats are likely to discourage Brasilia from making sharp cuts in public employee compensation, and the new investment controls will have little immediate impact on spending.

- The other sticking point in the negotiations is Brazil's complex indexing system. Fearful of the social consequences of dismantling the system, Brasilia has proposed manipulating the index to provide less than 100-percent linkage. The IMF, however, wants a break in the automatic wage-price adjustment mechanism. [redacted]

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We believe that Brazil will reach a settlement with the IMF, but negotiations will most likely be difficult. Both Brasilia and the IMF have considerable stakes in a successful outcome and both want to avoid the consequences of a collapse. Still, the Brazilian Government has become worried about the political fallout of the deepening recession and is resisting tougher steps. [redacted]

The Alternative to an IMF Accord

If the IMF renegotations are not settled by the end of July, the Brazilian Government probably will declare a limited debt moratorium. By this time, foreign payments arrears very likely will have shot up sharply, perhaps to more than $2 billion. Moreover, growing uncertainty and diminishing confidence would prompt bankers to withdraw more of their short-term trade financing and interbank deposit support, further aggravating Brazil's desperate foreign exchange reserve position. [redacted]

[redacted] Brasilia has been devising a contingency moratorium plan. Such an action probably would be applied only to principal payments and would be intended only for a short period of time. We believe that Brazil would hope that this type of a moratorium would provide opportunities for a new debt rescheduling plan—perhaps with substantial extensions of repayments terms and a reduction of interest rates. [redacted] 25X1

Economic Performance Scenarios for the Rest of the Year

The direction that Brasilia chooses and foreign banker reactions will influence the depth of the country's recession. A decision by the government to stay with an IMF program and accede to the required conditions should net Brazil several billion 25X1 dollars of additional foreign funds to support crucial import and investment activities. By contrast, if 25X1 the government opts for a moratorium, no net inflows of foreign private loans would be forthcoming until a new financial package is arranged. The Brazilian Government undoubtedly will balance these considerations against its own political exigencies. [redacted] 25X1

The IMF Route. A revised stabilization agreement would not only free disbursement of withheld IMF and bank funds but would clear the way for Brazil to solicit new funds. Despite sharp import cuts, we estimate that Brazil would require at least an additional $2.5 billion in new money to cover its projected $7 billion current account deficit. Exports almost certainly will not attain Brasilia's original projected level of $23 billion because of slumping demand for its manufactures and raw materials such as iron ore. By putting its IMF program back on track, we believe creditor banks will raise another large loan to enable Brazil to fill its financing gap. A few large money center banks are 25X1 recommending Brasilia seek $3-3.5 billion in new funds, but the cautious positions of a number of 25X1 European and small US regional banks could reduce this amount. [redacted] 25X1

Continuing foreign exchange constraints and more austerity will lead to as much as a 5-percent decline in Brazil's GDP this year. Brasilia will have to continue squeezing imports through the remainder

Brazil: Estimated Balance of Payments

	1982	1983	
		With IMF Agreement	With Moratorium [a]
Current account balance	−14.5	−7.5	−6.0
Trade balance	0.8	5.5	7.0
Exports	20.2	21.5	20.0
Imports	19.4	16.0	13.0
Net service balance	−15.3	−13.0	−13.0
Interest payments	11.0	9.0	9.0
Debt repayments	20.8	22.2	18.6
Long-term maturities	7.8	7.2	3.6
Short-term maturities	13.0	15.0	15.0
Gross foreign exchange requirements	**35.3**	**29.7**	**24.6**
Financed by:			
Net direct investment	1.0	0.5	0.4
Official and supplier credits	5.2	4.0	3.0
Loans	27.0	27.8	23.8
Bridge operations	4.0	−3.6	−2.5 [b]
Short-term rollovers	10.0	15.0	15.0
Short-term borrowings	0.5	1.0	1.5
Long-term credits	12.5	15.4 [c]	9.8 [d]
Other	2.0	−2.6	−2.6

[a] Assumes Brazil declares a moratorium on amortization payments at the end of July.
[b] Assumes Brazil suspends repayment of bridge loans to foreign banks.
[c] Includes $2.5 billion from the IMF and an anticipated new $2.0 billion foreign bank loan.
[d] Excludes not only new loan but also currently deferred IMF and foreign bank payments on existing loans.

[redacted]

of the year, forcing manufacturers to scale back production because of inadequate supplies of critical imported industrial materials. Furthermore, large cuts in state enterprise spending and continuing high real interest rates will assure declining investment activity for some months to come. Falling national output will probably boost unemployment rates close to double digits and heighten the risk of more wildcat strikes and cost-of-living demonstrations. [redacted] 25X1

The Moratorium Route. Brazil's choice of a debt moratorium would very likely entail a freeze of short-term funds—including trade financing and interbank deposits—and a temporary deferral of amortization payments on medium- and long-term debt. Although a few large US money center banks might favor a moratorium of this type, we believe most banks would discontinue new lending activity until new austerity measures and debt rescheduling agreements can be arranged. [redacted] 25X1

Denied access to its principal source of funds through yearend, Brazil, we believe, would have to slash imports by 40 percent in the second half. Sharply reduced availability of imported oil and raw materials would cause industrial and commercial output to plummet, and GDP could drop more than 10 percent for the year. Commodity shortages would very likely send inflation rates into the 150- to 200-percent range. Unemployment rates would climb—probably to the flashpoint for major social and political turmoil. The government's ability to deal with the resulting unrest could be sorely strained, and further movement toward political liberalization could be threatened. [redacted] 25X1

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Implications of a Moratorium

A decision to break off talks with the IMF and to temporarily suspend amortization payments to foreign banks would most likely be accompanied by a shakeup within President Figueiredo's three-man economic policy team. [redacted] foreign banks have lost considerable confidence in the economic management abilities of Planning Minister Delfim and Finance Minister Galveas. Central Bank President Langoni also is vulnerable because of his past staunch defense of IMF austerity policies. [redacted] We believe that even a limited moratorium would imply past economic policy failures and would likely augur the emergence of a new economic team. [redacted]

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The successors to Delfim and other economic policymakers would face two unattractive policy options. They could—as we believe likely—seek a compromise with the IMF and a return to the suspended stabilization program. Brasilia would have to push harder to achieve important economic adjustments than it has up to now. The political price that the ruling government party would have to pay could be heavy. Alternatively, Brasilia's preoccupation with social discontent during the early weeks of a moratorium could lead Brazil's new economic leaders to adopt more growth-oriented policies. Such policies probably would exacerbate existing distortions in the economy, drive up inflation rates substantially, and enlarge the already major role of the public sector. [redacted]

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[redacted]

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Venezuela: Stumbling Through Debt Talks [redacted] 25X1

Venezuela, once one of Latin America's most attractive borrowers, has been in serious financial straits for over a year. Sharply lower oil income and rampant capital flight led in March to the imposition of exchange controls and forced Caracas to suspend most principal payments on its large maturing debt. [redacted]

After three months of negotiations, Venezuela and its bank advisory committee have made little progress in refinancing short-term debt. Bankers are convinced that Caracas has neither the resolve nor the skill to manage its economy and insist that Venezuela submit to an IMF adjustment program. [redacted]

We believe the Herrera government will seek to delay signing a refinancing agreement requiring IMF austerity until after the December Presidential elections. Instead, Caracas will implement a patchwork of policies aimed at averting a liquidity crisis and will appeal to Washington for direct financial assistance rather than make necessary economic adjustments. [redacted]

The 10-Year Borrowing Binge, 1973-82

Despite the massive influx of oil revenues over the past decade, Venezuela has been one of the Third World's largest borrowers. Caracas turned to eager international lenders to finance ambitious development projects, while its state corporations borrowed short term to cover funding shortfalls. Consequently, Venezuela's total external debt soared to an estimated $34 billion by the end of 1982 from a mere $4 billion in 1973. [redacted]

Venezuela: Foreign Debt Profile

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	1979	1980	1981	1982
	Billion US $			
Total external debt [a]	23.7	27.0	30.3	33.7
Medium- and long-term (MLT) debt	12.3	14.2	15.9	19.1
Short-term debt	11.4	12.8	14.5	14.7
Debt servicing	3.3	5.3	6.4	6.8
Interest	2.0	3.0	4.1	3.7
Amortization (MLT)	1.3	2.3	2.3	3.1
Total exports	14.4	19.0	20.1	16.6
GDP	48.9	59.6	67.7	69.3
International reserves [b]	13.7	18.4	18.6	11.3
	Percent			
Ratio of:				
Short-term to total debt	48	47	48	44
Debt servicing to exports	23	28	32	41
Debt servicing to GDP	7	9	9	10
Debt servicing to reserves	24	29	34	60
Debt servicing and short-term obligations to exports	102	95	104	130
Debt servicing and short-term obligations to reserves	107	98	112	190

[a] Including public and private obligations.
[b] Excluding 11.46 million troy ounces of gold holdings, revalued in 1982 to $300 per ounce for a total of $3.4 billion. Includes reserves of the National Oil Company (PDVSA) and the Venezuelan Investment Fund.

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In a favored position as an oil supplier in a boom market, Caracas exercised little control over external borrowings, especially in the short-term markets, and managed its foreign funds poorly. As a 25X1 result, nearly one-half of total foreign debt now carries maturities of one year or less, leaving Venezuela highly vulnerable to changing conditions in international capital markets. Meanwhile, debt servicing requirements rose steadily, from $400 million in 1973 to an estimated $6.8 billion last year. [redacted]

Debt Servicing Becomes Unmanageable

The depth of the problem became apparent as Venezuela's financial position eroded steadily last year, dealing a sharp setback to lender confidence. Oil revenues—which account for about 95 percent of export earnings—dropped 20 percent and heightened banker concern about debt servicing. Moreover, a serious loss of confidence on the part of domestic businessmen caused capital flight to escalate, draining more than $5 billion in foreign reserves in 1982, according to Central Bank estimates. [redacted]

Poor financial planning added to Venezuela's debt difficulties. A refusal to pay high interest fees aborted the syndication of a large refinancing loan in March 1982, which would have improved the maturity structure of outstanding credits. Subsequently, the Mexican and Argentine repayment problems reinforced lenders' reluctance to roll over maturing short-term loans. In September lenders began demanding repayment, which further drained reserves. [redacted]

The government's debt crisis deepened early in 1983. Against the Central Bank's nongold foreign reserves of only $7.5 billion, Caracas faced potential demands for the repayment of $13.7 billion in maturing short-term debt and the need to fund a projected $2 billion current account deficit. Simultaneously, its access to new credit virtually ceased in January because of mounting fears of a precipitous drop in OPEC oil prices, another surge in capital flight, and the failure of Venezuelan state companies to make debt servicing payments. [redacted] 25X1

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The Early Venezuelan Response

Caracas finally took some stronger actions in February to shore up its financial position. It suspended foreign exchange transactions for one week and announced the imposition of exchange controls, the first in 20 years. The government introduced a three-tiered exchange system aimed at protecting reserve levels while preventing sharp price increases for basic consumer imports. These moves were not well received by bankers, who continued to resist new lending. [redacted] 25X1

The government suspended principal payments on most types of public external debt for 90 days in March to gain some breathing room while it negotiated with international banks on the rescheduling of short-term credits. A 13-bank advisory committee was set up in New York to handle the Venezuelans' rescheduling requests. [redacted] 25X1

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Venezuela's capability to deal with its problems has increasingly come into question. Even before serious discussions could begin, Venezuela's financial team needed banker assistance in compiling accurate data on the debt profile, the amounts to be refinanced, and realistic economic and financial projections for 1983. Moreover, political infighting between the President's two main economic advisers—Finance Minister Sosa and Central Bank President Diaz Bruzual—reinforced bankers' beliefs that Caracas lacked a coherent strategy. [redacted] 25X1

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Venezuela: Current Account *Billion US $*

	1979	1980	1981	1982 [a]	1983 [a]
Trade balance	4.4	8.3	8.0	3.4	4.3
Merchandise exports, f.o.b.	14.4	19.0	20.1	16.6	14.3
Oil	13.7	18.3	19.1	15.7	13.3
Other	0.7	0.7	1.0	0.9	1.0
Merchandise imports, f.o.b.	10.0	10.7	12.1	13.2	10.0
Net services and transfers	−4.0	−4.7	−4.1	−6.9	−6.0
Current account balance	**0.4**	**3.6**	**3.9**	**−3.5**	**−1.7**

[a] Estimated.

[redacted]

The Venezuelan economic team also demonstrated reluctance to undertake adjustment measures. Although Sosa hinted that policies would be toughened, the Herrera administration has failed to make any meaningful cutbacks in spending or consumption. According to Embassy sources, Herrera refuses to implement tough austerity policies, claiming they would precipitate social unrest in an election year. Instead, Caracas has utilized stopgap measures, such as restraining imports by limiting dollar availability through both the government's exchange office and commercial banks. [redacted]

Bankers Get Tough

International lenders have been extremely critical of the government's response to payments problems. [redacted] the government is proving itself incapable of administering the patchwork exchange system and has obstructed timely debt servicing. The private sector has been largely unable to obtain preferential dollars for debt servicing purposes since the exchange system was imposed, forcing some banks to move loans to nonperforming status. Meanwhile, difficulty in obtaining foreign exchange has caused various state corporations to fall behind on their interest payments. [redacted] 25X1

Starting in May, bankers began insisting that Caracas submit to an IMF adjustment program before they would proceed with refinancing. Specifically, the bank advisory committee urged Venezuela to seek a standby agreement, which, according to press and Embassy reporting, could garner a maximum of $4.5 billion over three years. In return for financial support, according to the same sources, the IMF would require Caracas to:

- Gradually unify the present three-tiered exchange system and remove import controls.
- Eliminate consumer price subsidies, particularly for domestic petroleum products and food. 25X1
- Reduce budgetary expenditures, particularly for state corporations, and increase prices of government services.
- Restrain wages and continue restrictive credit policies. [redacted] 25X1

The Current Impasse

With his party trailing far behind in the campaign for the December election, President Herrera continues to firmly resist adoption of what he considers an unreasonably tough IMF program. Instead, Venezuelan officials announced on 3 June they would seek up to $2.8 billion in unconditional drawings from the IMF to avert foreign financing problems in 1983. Caracas hoped to obtain half of that amount through use of its net credit position with the Fund, and it has applied for another $1.4 billion from the Compensatory Financing Facility based on the decline in oil export revenues. [redacted]

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The announcement that Caracas was not seeking an IMF standby set back its efforts to gain banker support for a rescheduling plan. As presented to the banker advisory committee in early June, Sosa requested that payments of $13.7 billion in 1983 maturities and $2.6 billion in 1984 maturities be stretched out through 1991 with a four-year grace period. In turn, Sosa promised bankers to eliminate some price subsidies, reduce expenditures by 10 percent, and introduce fiscal reforms—but not until 1984. [redacted]

Private bankers rejected Sosa's adjustment plan as inadequate. They stressed that refinancing talks will proceed only after Venezuela successfully negotiates an IMF adjustment program. [redacted]

Muddling Through 1983

Although negotiations are deadlocked, Caracas has recently gained some breathing room. The banker advisory committee recommended an extension of the postponement on principal payments from the end of June to the end of September because it realized it lacked sufficient leverage to force Caracas to adopt a standby. Until a comprehensive refinancing scheme is concluded, however, lenders will be likely to resist extending any new credits, thus forcing Caracas to survive on existing reserves. [redacted]

The Herrera government probably believes it can avoid the political embarrassment of lender-induced austerity through use of these reserves. Indeed, according to Embassy reporting, the Central Bank's nongold foreign exchange reserves—now approximately $6 billion—are sufficient to cover the projected balance-of-payments deficit through the December election period without a major injection of funds. [redacted]

The Herrera administration is gambling that it can escape IMF austerity, obtain some debt relief, and still avert serious cash problems. To attain these objectives, the Venezuelans will most likely:

- Initiate negotiations with the Fund in an effort to keep credit lines open but delay signing any standby to avoid domestic political repercussions.
- Make some minor economic adjustments to prevent a breakdown in cooperation with bankers that would jeopardize the standstill on payments.
- Use reserves and unconditional drawings from the Fund to maintain essential imports and interest payments.
- Maintain severe restrictions on the availability of dollars for nonessential imports to limit reserve drawdowns. [redacted]

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We believe this strategy will fail to achieve all of its objectives. Bankers almost certainly will press Caracas to adopt austerity. According to press reports, the IMF has said it will set tougher economic conditions on Venezuela's request for a Compensatory Finance Loan. These would include the adoption of an adjustment program for any drawings in excess of 50 percent of the member's quota. [redacted] 25X1

In our view, Venezuela will obtain only limited debt relief. Their intransigence over the IMF's conditions will preclude a long-term refinancing plan. [redacted] the banks would then be likely to reschedule 1983 maturities for one year only, forcing the new administration to negotiate in 1984. [redacted]

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These lending cutbacks will probably cause Venezuela's cash strains to intensify. [redacted] Venezuelan firms are already

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experiencing sharp cutbacks in trade credits. Simultaneously, Caracas will need to limit the availability of dollars for imports, and we anticipate more serious shortages of key raw materials and foodstuff imports. [redacted]

The Fallout

Venezuela's domestic economic recession will deepen by the time of December elections, regardless of whether Herrera succeeds in escaping the full brunt of lender-imposed austerity measures. According to press reports, many plants have begun to shut down operations because of a lack of key imported parts, which will worsen as existing inventories are depleted. Other firms are faced with a severe profit squeeze because of price controls and declining domestic sales. According to the US Embassy, the government's policies are causing mounting layoffs and bankruptcies. We estimate that GNP will decline 4 to 7 percent this year, with unemployment nearing 20 percent by December, and inflation ranging between 15 and 20 percent. [redacted] 25X1

Herrera's policies will also heighten the country's vulnerability to unanticipated external shocks. Any deterioration in world oil markets will rapidly drain remaining liquid reserve holdings. With easy access to IMF funds blocked, Caracas would then soon encounter severe cash management difficulties. [redacted] 25X1

The government's delaying tactics could also provoke an unexpected confrontation with bankers. We remain concerned that smaller banks with large interest arrearages on their loans to Venezuela will take actions to force payments. Earlier this year, some banks initiated legal action to declare loans in default. Although a rash of court actions is unlikely, bankers could also demonstrate their pique by abruptly retracting existing trade credits—comparable to the cessation of credits to Chile in January—precipitating a liquidity crisis. [redacted] 25X1 25X1

US commercial interests have been hard hit by Venezuela's intensifying foreign exchange squeeze. Over the near term, we foresee continued delays by Venezuelan borrowers on servicing their $12 billion US debt and persistent difficulty in clearing accounts with US suppliers. US exporters will be hurt by import curbs. We believe Caracas will seek financial assistance from the United States to blunt the need for economic austerity. [redacted] 25X1

[redacted] 25X1

Argentina: Difficulties with the IMF Ahead 25X1

Argentina has for now halted the economic slide triggered by the Falklands conflict as the current economic team reversed the populist policies of its predecessors and managed to sign an agreement with the IMF. Buenos Aires has stayed close enough to its IMF program to allow continued drawings. A major refinancing effort designed to ease the servicing of nearly $39 billion in foreign debt is also being put into place. 25X1

We expect Argentina will have difficulty complying with IMF targets as fiscal discipline is relaxed on the road to elections in late October. The incoming civilian regime will inherit an economy in need of austerity and reforms, but it will be under pressure from constituents to push economic recovery. We expect the new government will try to balance these conflicting demands, but this probably will cause frictions with US and foreign bankers if the civilians again opt for populist growth policies. 25X1

Downward Spiral

Even before the Falklands crisis, Argentina had not seen any substantial growth since 1979. The economy contracted by roughly 5 percent in 1980-81. Inflation hovered just above 100 percent and real wages contracted. Payments problems mounted because of the highly overvalued exchange rate, higher oil prices, and rising interest payments. 25X1

In late 1981, Economics Minister Alemann aimed at improving the economy by implementing free market policies and austerity measures. His reforms cut inflation and restored stability to Argentine foreign exchange markets in early 1982, but they fell casualty to the Falklands conflict. Defense spending pushed prices higher, while Argentina's external accounts were weakened by war-induced export shortfalls, capital flight, and the cessation of new lending. 25X1

After the conflict, President Bignone and his new Economics Minister Dagnino opted for populist economic policies. To spur growth, they announced lower interest rates, granted public-sector wage hikes, and initiated a domestic debt refinancing program. Price controls were implemented in an attempt to hold down inflation. The payments accounts were bolstered by devaluing the commercial peso to boost exports while retaining tough import controls. 25X1

These policies were only effective in moderating the economic slowdown. Although economic activity was contracting at a 10-percent annual rate in the first half, Buenos Aires finished the year with only a 5.7-percent reduction in GDP. Despite promises to control inflation, however, consumer prices predictably headed higher and were climbing at a roughly 200-percent annual rate by yearend. 25X1

The switch to populist policies and a $1.4 billion jump in public sector arrears caused foreign banker confidence to collapse. Bankers refused long-term refinancing for maturing debt and all new lending requests. With debt servicing becoming unmanageable, Argentina hovered on the verge of insolvency. 25X1

Regaining Control

In August of last year Economics Minister Dagnino and Central Bank President Cavallo resigned. They

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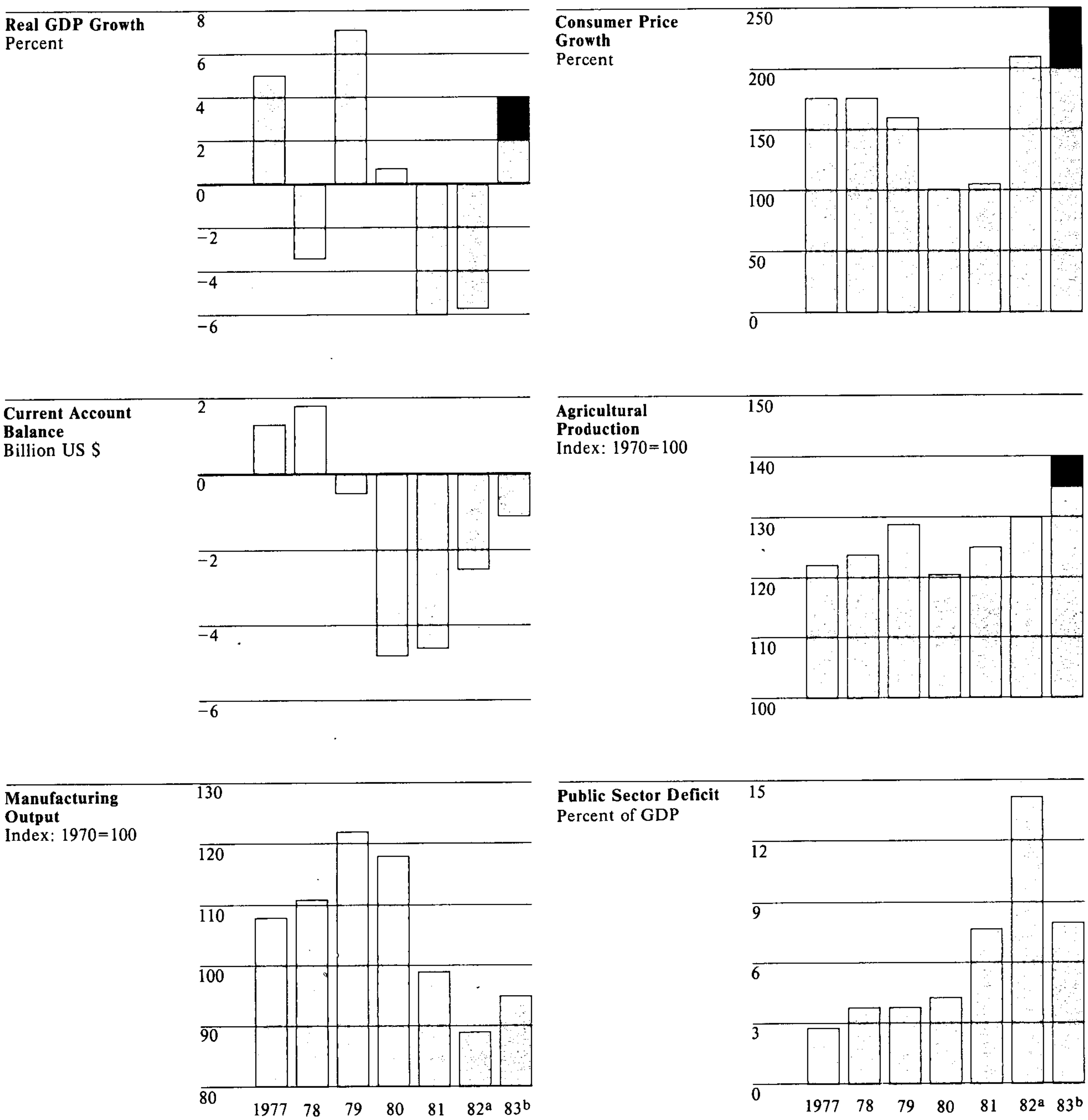
Argentina: Economic Indicators



[a] Estimated.
[b] Projected.

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were replaced by Jorge Wehbe and Julio Gonzalez del Solar, respectively. To mend fences with the international banks, the new economic team initiated discussions with the IMF. Despite resistance from hardline nationalists at home, the Embassy reported the economic team gained support for the stabilization program by indicating that adjustments were necessary to begin a recovery of real output, to keep a lid on inflation, and to generate an improvement in the balance of payments.

The hub of Wehbe's plan to bring the debt burden under control is a $2.2 billion IMF package made up of a $1.65 billion standby agreement and $570 million in compensatory financing for reduced export earnings. About $900 million was made available when the package was approved in January 1983, with the remaining $1.3 billion to be drawn in four equal installments over the following 15 months as long as Buenos Aires complies with the Fund agreement. 25X1

The Wehbe and Gonzalez del Solar program reflects a return to more orthodox and austere policies. According to Embassy reports, they have moved to bring government spending under control and restrain credit. Public-sector prices—particularly for electricity and petroleum products—have been increased faster than inflation to eliminate subsidies and reduce consumption. Higher interest 25X1 rates, a return to a unified exchange rate, and daily depreciation of the official exchange rate to keep pace with inflation have been implemented to 25X1 reduce capital flight and achieve a large trade surplus.

The Early Results

Early indications are that Buenos Aires has managed a creditable economic performance under the 25X1 IMF program. A record 15.1-million-ton wheat crop has boosted agricultural production and export earnings. The Embassy reports a $1.3 billion trade surplus was recorded through April, fortifying the Embassy's expectations of a $3 billion surplus for the year. According to press reports, the favorable trade balance has reversed the declining trend of reserves and put them on the rise since mid-April. With the return of some normalcy, capacity utilization in the industrial sector has risen significantly from a year earlier. As a result, Wehbe's claim of a 2-percent annual growth rate for the first quarter is reasonable. 25X1

IMF Standby Agreement

Argentina will remain eligible to draw under an IMF standby agreement this year if it limits the growth of net central bank credit, maintains an overall balance-of-payments deficit of not more than $500 million, reduces the public-sector deficit to 8 percent of GDP, and keeps the growth of foreign debt to no more than $2 billion. Buenos Aires is also required to drop rebates for exports to new markets and gradually eliminate minimum foreign financing requirements for imports. External arrears are to be eliminated by 30 June and a schedule for phasing out both multiple currency practices and restrictions on international payments must be agreed on with the Fund by 31 July. Import restrictions for balance-of-payments reasons are prohibited.

Beyond the IMF agreements, Argentina has established some additional austerity targets:
- *It has declared that it will limit real public-sector wage increases to 5 percent this year.*
- *It will eliminate price controls as inflation subsides.*
- *Fuel prices are to be raised 3 percent monthly in real terms during most of 1983.*
- *Controlled lending rates will be set equal to the level of inflation.*

Argentina: Balance of Payments *Million US $*

	1979	1980	1981	1982 [a]	1983 [b]
Current account balance	−536	−4,767	−4,592	−2,549	−1,100
Trade balance	1,110	−2,519	−237	2,290	2,900
Exports, f.o.b.	7,810	8,021	9,143	7,620	8,000
Imports, c.i.f.	6,700	10,540	9,380	5,330	5,100
Net services and transfers	−1,646	−2,248	−4,355	−4,839	−4,000
Net interest	−493	−949	−2,964	−4,508	−4,100
Capital account balance	4,784	2,187	975	−3,160	
Direct investment	265	788	904	270	
Banking system	−175	−518	39	500	
Trade finance [c]	778	−115	−3,504	−2,405	
Other	3,916	2,032	3,536	−1,525	
SDR allocation and reserve valuation adjustment	205	−139	−293	−110	
Change in reserves	**4,453**	**−2,719**	**−3,910**	**−5,819**	

[a] Estimated.
[b] Projected.
[c] Includes trade-related lags and leads.

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Inflation has yet to respond to the price controls. Past rapid monetary expansion, cuts in government subsidies, and higher imports costs have caused consumer prices to increase 75 percent through May. Moreover, press reports indicate that, in the first two weeks of June alone, inflation jumped another 15 percent as prices jumped in response to the redenomination of the currency.

Economic recovery has helped the economic team defuse some domestic criticism of austerity, thereby keeping the IMF program on track. Delays in starting the government investment program have also kept spending down, assisting the team's efforts to comply with IMF domestic performance targets. As a result, Argentina was able to draw $325 million from the Fund in May. All second-quarter performance targets except the elimination of arrears appear to have been met. Commercial bank footdragging on providing new money has left Buenos Aires short the funds it had planned to use in repaying arrears. At this juncture, we believe the IMF is not likely to stop drawings under the standby agreement; consequently, another $325 million will become available by late August. 25X1

Problems With Bankers 25X1

Despite compliance with the IMF thus far, Buenos Aires has received only small amounts of new credit from international bankers. The delays in new lending, in turn, have forced Buenos Aires to selectively delay repayments. Since October 1982, there have been no debt principal payments other than for the elimination of commercial arrears in order to encourage a continued flow of short-term trade credit. Additionally, Argentine borrowers have fallen behind in meeting interest payments. 25X1

Delays in making debt repayments has hindered Buenos Aires' ability to draw new credit. [redacted] negotiations for a $1.5 billion medium-term loan have dragged on since January. Progress has been blocked because of Argentine arrearages, exchange restrictions on British banks, and a dispute with bankers about the Argentine bankruptcy code. With British banks now eligible to apply for remission of profits, creditors indicate they may finalize the $1.5 billion agreement and disburse the money in July. [redacted]

The government's rescheduling plans include consolidating $6 billion in 1982 principal arrears and $8.7 billion in 1983 maturities into new loans it hopes to repay over 7 years (including 3 years grace). Buenos Aires has yet to conclude its private-sector debt refinancing program, a technical impediment for rescheduling loans held by the public sector. Recently announced rules governing the repayments of debts with exchange rate guarantees may pave the way for future progress in stretching debt into longer-term maturities. In May, creditors agreed to accept new three-year maturities for $1.4 billion in currency swaps. [redacted]

Difficulties Ahead for Bignone

The outgoing military government would like to leave office on a favorable economic note. Based on the Argentine financial press, we believe that President Bignone will loosen the purse strings in the second half. In our view, the Bignone government will very likely grant new wage hikes to placate labor, increase public investments to buoy the recovery, and tighten price controls to blunt the impact of rising prices on living standards. Such politically motivated largess would stand a good chance, however, of undoing the progress Wehbe and Gonzalez have been able to achieve. [redacted]

At this juncture, most forecasts expect to see a modest economic recovery in Argentina this year. Growth in the 2- to 4-percent range is likely, led by another good agricultural harvest and industrial recuperation. Purchasing power and living standards, however, are almost certain to be eroded by inflation in the 200-percent range. Continuing large grain exports will also help to create a $3 billion trade surplus. [redacted]

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By pushing more strongly for a recovery, however, we expect—as do most private-sector economists—that Argentina will encounter increasing difficulty in complying with its Fund program by the fourth quarter. The relaxation of austerity will likely push public-sector borrowing and money supply growth beyond IMF limits. Although international lenders have taken a generally cooperative attitude toward the Bignone government, we are unsure about how they will react to such policy moves. If bankers feel that higher spending is necessary to avert serious social unrest, we believe there would be little, if any, fallout. Alternatively, reckless spending would, in a worst case, probably cause the IMF to suspend drawings against the standby arrangement. Under these conditions, we believe private bankers would be quick to halt disbursements on any new portions of the refinancing plan. The potential for such actions will increase if campaign rhetoric comes down particularly hard on foreign lenders or if debt repudiation becomes a central theme. [redacted]

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Economic Problems for the Civilian Regime

The election on 30 October will pit the Peronists against the Radicals—two center-left parties—for control of the next government. Whichever party emerges victorious, they will inherit a sluggish economy vulnerable to external shocks. Although austerity will be required to lay the foundation for economic improvements, such an approach will be unappealing to any new government anxious to reward its major constituents. [redacted]

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The new civilian government will most likely attempt to broaden its political support by sustaining

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economic growth. Its ability to resort to massive wage and spending hikes, however, will be constrained by the continuing heavy debt servicing burden. With its options circumscribed, we believe that the next government will most likely try to follow a middle course between strict compliance with the IMF program and growth-oriented policies. 25X1

Insofar as we can now predict, future spending policies probably will reflect the past tendencies of these parties. To placate its labor support, a new Peronist government—currently favored to win the elections—will be likely to resort to policies favoring income redistribution and higher public spending to improve the workers' lot. A government headed by the Radical party—favored by the middle classes—would be more inclined to push business-oriented policies. In any event, either party will have a difficult time pushing economic recovery while meeting IMF performance targets. 25X1

Argentina's current IMF agreement will expire soon after the new civilian government takes office. To retain foreign financial support, we expect the civilian government to negotiate a new agreement. Such an agreement will be required to sustain the financial rescue plan and obtain new loans necessary to sustain economic recovery. In a worst case, however, a very weak civilian government facing tough IMF demands for austerity might declare an indefinite moratorium on debt principal and interest. Although such a course would temporarily alleviate financial constraints, it would probably precipitate default actions by creditors and cut off Argentina from necessary foreign credits for some time to come. 25X1

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Argentina: Disbursed External Debt

	1979	1980	1981	1982 [a]
	Million US $			
Debt	19.3	27.2	35.7	35.0
Private sector	9.1	12.7	15.6	14.0
Public sector	10.2	14.5	20.0	22.0
Debt service by original maturity	2.2	3.5	6.3	10.1
	Percent			
Public sector by creditor				
International organizations	12.9	7.8	6.0	5.6 [b]
Official creditors	4.7	2.6	1.9	1.6 [b]
Banks	55.1	71.0	67.4	64.2 [b]
Bond holders	14.7	10.1	18.7	22.9 [b]
Private firms	12.5	8.5	5.9	5.6 [b]

[a] Estimated. Does not include $2.8 billion in arrearages.
[b] As of 30 September.

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Andean Countries: Grappling With Payments Problems [redacted] 25X1

Since January, the retraction of short-term credit lines to Chile and Peru, cutbacks in private bank lending to the other borrowers, and weak export performance have caused severe financial strains throughout the Andean region. Chile—forced to suspend principal repayments in January—is still struggling to get its financial program back on track. Peru and Colombia are encountering difficulty in obtaining new money, but have managed to avert foreign exchange crises thus far. Bolivia and Ecuador have resorted to allowing arrearages to build up on commercial debt repayments while seeking to resolve their differences with the IMF. [redacted]

Adjustments are now under way to relieve these financial stringencies, but difficulties persist. Under IMF guidance, Andean countries are making an effort to improve external accounts by pushing exports and cutting imports. The Fund, in turn, is pressing commercial bankers to provide the new loans and refinancings necessary to shore up the position of these beleaguered borrowers. Although progress is being made, we believe US financial institutions—with some $15 billion in loans to the region—will remain vulnerable to debt servicing disruptions. Cash strains will persist because of a weak export recovery. New loan arrangements could also be jeopardized by social unrest in the region. Moreover, the smaller Andean debtors could deal severe setbacks to banker confidence by continuing to drum up support for a debtor's cartel. [redacted]

Financial Shockwaves

An abrupt contraction in short-term credit lines and a squeeze on new longer-term lending worsened the financial position of the Andean countries in early 1983. In January, Chile's cash position—already weakened by declining exports, capital flight, and a slowdown in lending—became critical when bankers ceased lending in a financial dispute with the government. Despite its compliance with the IMF, Peru encountered difficulty in obtaining new loans while facing demands for the repayment of maturing credits. Colombia encountered problems in raising an $80 million balance-of-payments loan early this year because creditors were reluctant to increase their exposure in the face of unattractive lending terms sought by Colombia. Ecuador and Bolivia, both lacking IMF agreements, were unable to obtain new credits and roll over maturing loans. [redacted] 25X1

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With bankers reluctant to provide new loans, most Andean countries moved unilaterally to relieve financial stringencies, and moratoriums on debt repayments proliferated early this year throughout the region:

- Santiago declared a 90-day freeze on principal repayments on bank loans in January and then requested another extension in April.
- Lima decreed an extension of maturing short-term credits in March and in May suspended principal repayments on official debt in advance of Paris Club rescheduling. 25X1
- Quito and La Paz—with meager reserve cushions—continued to resort to commercial arrearages.

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Andean Countries:
Financial Status at a Glance

Country/Total Debt	*Key Trends*
Chile/$17 billion	*Principal payments still frozen . . . recorded small trade surplus through May . . . temporarily out of compliance with IMF agreement, but operating under "shadow program" with revised targets . . . refinancing program moving well but encountering some resistance to new money requests.* [redacted] 25X1
Peru/$11 billion	*Encountered difficulty in obtaining new loans and trade credits despite compliance with IMF . . . Meager trade surplus unable to alleviate cash strains . . . seeking to refinance nearly $4 billion in maturing debts . . . eligible to draw $310 from IMF through February 1984, but struggling to obtain $770 million commercial bank financing . . . official payments suspended until July Paris Club meeting considers $1.3 billion debt.* [redacted] 25X1
Colombia/$10 billion	*Difficulties in obtaining new money to finance external deficits . . . fast rate of foreign exchange depletion despite corrective measures . . . will have to pay more for credit later in the year . . . may have to restructure debt by 1984.* [redacted] 25X1
Ecuador/$7 billion	*Protracted IMF negotiations has caused bankers to cut new credit and trade financing . . . Despite a $197 million trade surplus through March, arrearages now in $200 to $300 million range . . . IMF recently approved $170 million standby while bankers are arranging financial bailout package . . . public debt payments suspended until completion of $2.7 billion Paris Club rescheduling.* [redacted] 25X1
Bolivia/$4 billion	*Foreign exchange scarce despite small trade surplus and a $25-30 million drawing under IMF compensatory financing program . . . has renegotiated $700 million in debt to its creditor banks by promising to reach agreement with the IMF by October . . . negotiations for a $119 million IMF standby loan are stalled because of failure to implement austerity measures . . . seeking to renegotiate debts on a bilateral basis.* [redacted] 25X1

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In contrast, Bogota has remained current in making payments, but at the cost of drawing down its exchange reserves by $750 million in the first quarter, exceeding the loss for all of 1982. [redacted]

Payments Adjustments

According to Embassy reports and available trade statistics, three of the five Andean countries have somewhat improved their trade accounts this year.

Despite weak global recovery and a series of natural disasters, currency devaluations and import cutbacks have generated small individual trade surpluses throughout the region. Even so, cash strains persist because the trade improvements have fallen short of the continuing deficits in the service accounts. [redacted] 25X1

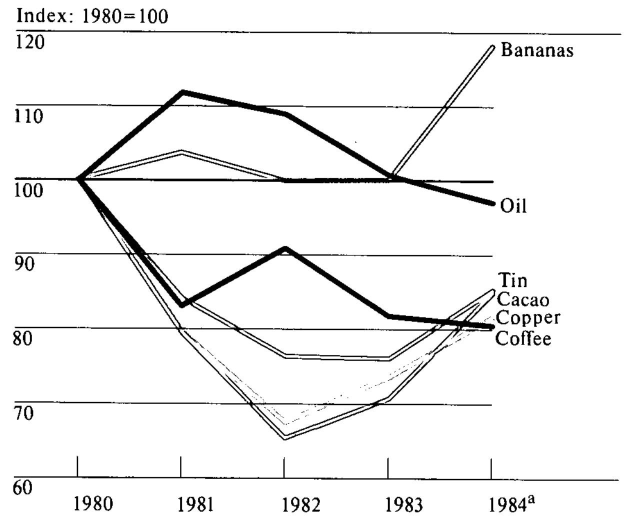
Chile has boosted exports while imports have declined, resulting in a $544 million trade surplus through May. [redacted] the current account deficit averaged $120 million monthly in the face of continuing high interest payments and capital flight during the first quarter. The 90-day commercial debt moratorium, however, slowed the rate of decline of reserves by February. [redacted] 25X1 25X1 25X1

Ecuador managed a $197 million trade surplus through March by using tough import controls. Export gains, however, were constrained by the decline in the price of crude oil, agricultural export shortfalls caused by recent floods, and depressed world market prices for bananas, cocoa, and coffee. [redacted]

Colombia slashed imports to alleviate payments strains. With exports down during the first quarter, the Betancur administration hiked tariffs and depreciated the peso to slow imports. These moves helped produce a $235 million first-quarter trade surplus but barely alleviated cash problems. Capital flight and declines in interest earnings, tourism receipts, and remittances from Colombians living abroad offset the trade gains. [redacted]

Peru moved against the trend of trade improvements. On the basis of the Central Bank's revised projections, we believe trade was balanced, at best, in the first quarter. Although capital goods imports were slashed, export earnings from copper and oil remained depressed while flood and drought added to the food import bill. High interest charges and some prepayments for Mirage aircraft quickly ate up the available cash. [redacted]

Andean Countries:
Price Fluctuations of Key Exports



[a]Projected.

[redacted] 25X1

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Lower prices for Bolivia's key exports—natural gas and minerals—cut the January-March 1983 trade surplus 20 percent to $55 million, compared to the same period last year. Additionally, foodstuffs imports were increased to fill the gap resulting from weather-induced crop shortfalls. [redacted] 25X1

Seeking Financial Rescue

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To deal with debt servicing problems, international bankers have tried to reestablish orderly financial conditions. Nonetheless, the financial position of the Andean countries remains precarious. The IMF has moved to resuscitate negotiations with troubled borrowers, but progress has been uneven in concluding IMF negotiations. Consequently, private bankers have resisted extending large amounts of new credit. [redacted] 25X1 25X1

Chile. Shortly after an $880 million Fund package was approved in January 1983, Santiago acknowledged it was unable to meet IMF targets for reserves and net domestic assets of the central bank. After consultations, the Fund determined that Chile could get its program back on track by September under a "shadow program" of revised targets. In the interim the IMF would allow Santiago to draw $54 million in late July. [redacted]

Simultaneously, IMF Managing Director De Larosiere has taken the lead in dealing with international banks, urging them to commit the funds necessary to keep Chile's rescue plan afloat. Chile will obtain from bankers the refinancing of $2.4 billion in commercial bank loans and short-term credits, plus the restoration of $200 million in trade credits that were withdrawn early in the year. In addition, new medium-term loans totaling $1.3 billion are being sought. Despite some resistance by European and US regional banks, [redacted] about $1.1 billion of the medium-term loan has been committed thus far and the short-term loan has been oversubscribed. [redacted]

Peru. Its financial rescue package mainly involves the rescheduling of past debt. According to a press report, Lima and commercial banks recently agreed to consolidate about $2 billion in short-term trade credits into a new one-year loan and refinance $380 million in medium- and long-term maturities. Over $1.3 billion in official debts to Western governments are to be rescheduled through the Paris Club; socialist states have been asked to renegotiate terms on about $125 million due, according to press sources, for armaments purchased in the mid-1970s. The Paris Club is expected to meet in July to set the terms for refinancing of official debts, three-fourths of which is owed to France, the United States, Italy, West Germany, and Japan. [redacted]

Lima is requesting only modest amounts of new money this year. Despite a series of natural disasters, it stayed close enough to its specific IMF performance targets to remain eligible to draw some $310 million through February 1984 under its three-year, $715 million program. Consequently, commercial banks have agreed to provide $770 million in medium- and long-term loans—$320 million in debt rollover and $450 million in new money, which Lima will draw upon in July. [redacted]

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Ecuador. New bank credits and import financing dried up late last year in the wake of Ecuador's protracted negotiations with the IMF, causing the economy to falter. In May, however, the IMF approved a $170 million one-year standby loan under the condition that private creditors commit new money and make loan rollovers. The IMF financial bailout package requires bankers to (a) refinance $1.1 billion in existing loans; (b) provide a new $431 million line of credit; and (c) maintain trade credits at the $500 million level. Meanwhile, its public debt payments will remain suspended until completion of $2.7 billion Paris Club rescheduling, scheduled to begin at the end of July. [redacted]

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Bolivia. The Embassy reports that Finance Minister Machicado has promised to reach agreement with the IMF by October. Current negotiations, however, remain stalled on a $119 million standby loan because of the government's continuing failure to implement politically sensitive austerity measures. Despite the deadlock, La Paz has recently renegotiated some of its debt to the Bank of America–led consortium of 128 creditor banks. Under the terms of the agreement, La Paz agreed to pay $85 million in past due interest payments by the end of September. In turn, bankers will grant a

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Andean Countries: Current Account Balances

Million US $

	1981	1982	1983
Bolivia			
Trade balance	229	205	140
Imports, f.o.b.	680	655	660
Oil	0	5	10
Nonoil	680	650	650
Exports, f.o.b.	909	860	800
Oil	3	30	20
Nonoil	906	830	780
Net services and transfers	−541	−560	−580
Current account balance	−312	−355	−440
Chile			
Trade balance	−2,598	200	1,000
Imports, f.o.b.	6,558	3,600	3,450
Oil	960	615	575
Nonoil	5,598	2,985	2,875
Exports, f.o.b.	3,960	3,800	4,450
Oil	0	0	0
Nonoil	3,960	3,800	4,450
Net services and transfers	−2,271	−2,600	−2,600
Current account balance	−4,869	−2,400	−1,600
Colombia			
Trade balance	−1,662	−570	−500
Imports, f.o.b.	4,789	3,305	3,000
Oil	520	375	400
Nonoil	3,869	2,930	2,600
Exports, f.o.b.	3,127	2,735	2,500
Oil	350	180	150
Colombia (continued)			
Nonoil	2,777	2,555	2,350
Net services and transfers	−307	−645	−1,365
Current account balance	−1,969	−1,215	−1,865
Ecuador			
Trade balance	183	80	−100
Imports, f.o.b.	2,362	2,265	2,100
Oil	0	0	0
Nonoil	2,362	2,265	2,100
Exports, f.o.b.	2,544	2,345	2,000
Oil	1,560	1,350	900
Nonoil	984	995	1,100
Net services and transfers	−1,210	−1,270	−1,500
Current account balance	−1,027	−1,190	−1,600
Peru			
Trade balance	−548	−557	244
Imports, f.o.b.	3,803	3,787	2,786
Oil	0	0	0
Nonoil	3,803	3,787	2,786
Exports, f.o.b.	3,255	3,230	3,030
Oil	528	715	565
Nonoil	2,727	2,515	2,465
Net services and transfers	−1,132	−1,090	−1,144
Current account balance	−1,680	−1,647	−900

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two-year grace period on repayment of $440 million in debt servicing arrears and a four-year grace period on $250 million in principal maturing between now and 1985. Moreover, La Paz has approached the Netherlands, Belgium, and the United Kingdom for bilateral debt rescheduling. Representatives of these countries, however, reportedly indicated any renegotiations would have to be conducted through the Paris Club [redacted]

Colombia. Bogota continues to experience difficulties in raising new loans. [redacted] creditors are becoming unwilling to substantially finance Colombia's deficits in the face of mounting payments problems and sluggish domestic economic conditions. If Colombia fails to raise necessary funds in coming months, the government may be unable to avoid a debt financing crisis. [redacted]

The Dangers Ahead

The financial position of the Andean countries will remain difficult this year. Despite import cuts, we estimate the region will still show a combined $6.4 billion current account deficit in 1983. Weak exports will limit improvements and will most likely result from the sluggish rebound in world economic activity and the modest recovery in commodity prices. [redacted]

The inability to eliminate their payments deficits will leave the Andean countries vulnerable to additional lending cutbacks. Over the near term, we remain concerned about the increasing potential for social unrest in some of these countries. Labor unrest in Chile and terrorist activity in Peru will probably cause international bankers to drag their feet in honoring lending commitments necessary to obtain breathing room for economic adjustments. Moreover, additional economic-related protests in Bolivia and Ecuador would probably heighten banker concern about the ability of these governments to implement necessary stabilization programs. [redacted] 25X1 25X1

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At best, the Andean countries will continue to bump along until the world economy strengthens. If periodic funding gaps develop, as we believe is likely, the Andean debtors probably will attempt to avoid default, mainly by selectively delaying repayments. We also anticipate that these debtors will turn to Washington for direct assistance and new debt-rescheduling efforts. [redacted] 25X1 25X1 25X1

At worst, however, the smaller Andean debtors could resort to radical moves, causing a breakdown in cooperation with creditors. Although an outright debt repudiation is unlikely, [redacted] the Presidents of Bolivia and Ecuador are proponents of collective action to force renegotiation of foreign debts. [redacted] 25X1 25X1 25X1

[redacted] 25X1

25X1

Latin America: Prospects for Collective Action on Debt [redacted] 25X1

Latin American debtors have periodically raised the specter of collective action to ease the burden of their debt service. Although there is no evidence that the leadership of any of the large debtor countries is presently considering such a radical move, the possibilities for joint action by Latin American debtors to obtain better repayment terms on their more than $200 billion debt are being more widely discussed. While such a move would be highly disruptive to the current efforts to resolve the Third World's debt crisis, joint action would become far more attractive to the debtors if IMF-sponsored refinancing programs should falter. [redacted]

Heightened Discussion

Mounting debt servicing difficulties have once again led some Latin countries to propose jointly confronting bankers to force renegotiation of their debts. [redacted] smaller states like Ecuador, Nicaragua, and Bolivia have recently been proponents of collective actions to improve their bargaining weight. Last November, for example, Nicaraguan officials tried to drum up support for a joint debt moratorium, while Ecuadorean President Hurtado proposed in February 1983 a common response to the region's financial crisis. [redacted]

Although these initiatives failed to gain support, public demands for collective actions have increased. As austerity has taken hold, international bankers have reported that some Brazilian private businessmen have discussed the idea of a complete repudiation of foreign debt. Moreover, several Brazilian academics have publicly called for joint actions to foster easier repayment terms. In Argentina, Peronist leaders—likely to control the new civilian government in 1984—have espoused joint negotiations to achieve better refinancing terms, according to recent press reports. The economic adviser to Radical Civic Union presidential candidate Raul Alfonsin—the current underdog in the campaign—has proposed that a new Argentine civilian government should negotiate its external debt in concert with other Latin countries. [redacted] 25X1
[redacted] 25X1

Simultaneously, Latin governments have sponsored talks aimed at seeking ways to lessen collective debt problems. In April, the Group of 77 proposed that UNCTAD VI call on creditors to improve repayment terms for developing countries. The Economic Commission for Latin America issued a report in May calling for regional discussions and a common approach to the debt crisis. Moreover, the OAS recently scheduled a conference for September to study a joint approach to Latin American financial problems. Although these groups strongly deny any intent to form a debtor's cartel, they have heightened some banker's fears about the potential for such action. [redacted] 25X1

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Banker Concern in Perspective 25X1

Some international bankers are concerned that persistent debt servicing difficulties may cause Latin American countries to confront the banks as a bloc. In late April, for example, US bankers gave some credence to rumors that Brazilian President Figueiredo discussed such a proposal with Mexican

Chronology of Latin American Debt Talks

Date	Event	Comments
1982		
October	Bolivian President's invitation to talk with other government leaders about joint debt action	Bolivian President Herman Siles Suazo invited the leaders of Colombia, Ecuador, Panama, Peru, and Venezuela to confer on joint actions to renegotiate external debt. We have no evidence that meeting took place.
November	Nicaraguan support revealed	Nicaragua supported President Suazo's proposal and talked with several Latin American countries about a joint debt moratorium.
1983		
February	Ecuadorean President's letter	The US Embassy reports President Hurtado sent a proposal letter to ECLA, SELA, and all Latin American countries to seek a common response to the region's economic crisis.
	Latin American Economic System (SELA) meetings	At a SELA meeting held in Cartagena, Colombia, Latin countries called for improved loan terms. A month later, SELA called for industrial nations to create a fund to help LDCs meet interest payments on their foreign debt.
	Venezuelan call for a regional debt conference	A Venezuelan representative to the Organization of American States (OAS) proposed holding a regional debt conference within the OAS forum in September 1983.
March	New Delhi Nonalignment Summit	A measure under consideration at the Summit calling for "collective debt negotiations" was softened at Latin American insistence—probably that of Argentina—to read as calling for an "exchange of information on debt negotiations."
	Inter-American Development Bank meeting in Panama	An Ecuadorean proposal to band together smaller Latin American nations to obtain more advantageous terms from foreign banks received little support from other delegates.
April	G-77 ministerial meeting in Buenos Aires	Proposed that UNCTAD VI adopt measures that call for conversion of ODA loans to grants for all least developed countries and improved rescheduling terms—longer grace periods, lower interest rates, and extended periods of maturity—on official debt for all other LDCs.
May	The Economic Commission for Latin America (ECLA) report	The commission issued a report calling for regional discussions to develop a common approach to the Latin debt crisis.
	Declaration of Bogota	A group of Latin economists issued a call to world leaders, private banks, and international financial institutions to make available additional resources to smooth debt servicing difficulties.
Proposed Meetings, 1983		
July	ECLA	The economic working group will meet in Santo Domingo for followup discussions on Latin debt problems.
September	OAS	Regional conference to discuss debt problems.

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President de la Madrid during his state visit. [redacted]

[redacted] calls for regional financial cooperation could lead to a joint action by Latin debtors. [redacted]

Despite bankers' apprehensions, the leaders of large debtor countries are resisting radical alternatives to current financial programs:

- President de la Madrid has consistently reaffirmed his commitment to repay debt and has opposed calls for collective action.

[redacted]

- President Herrera in Venezuela has stated publicly that the upcoming Organization of American States debt conference should deal mainly with international financial reform, not proposals for radical action.

- A leading Chilean spokesman indicates the Pinochet regime will not join a cartel, while Peruvian President Belaunde continues to support his Finance Minister's rejection of calls for a joint moratorium. [redacted]

These leaders are motivated largely by economic self-interest. [redacted] they still believe their countries are better credit risks than their neighbors. Moreover, large banks are continuing to cooperate with them in their rescheduling programs, while the active involvement of the IMF is also tempering frictions between debtors and creditors. As long as bankers cooperate in refinancing, the larger states will most likely believe they have a better prospect of lining up refinancing on their own—and with better financial terms—than as part of a heterogeneous Latin American group. [redacted]

Prospects

Latin American governments—with the exception of Ecuador, Nicaragua, and Bolivia—are not calling for a joint payments moratorium or debt repudiation at the moment. Most countries appear willing to explore regional discussions—partly in the hope that these actions alone will prompt bankers to be more forthcoming—but apparently are not seriously pursuing bloc action. Indeed, without the participation of at least one of the major debtors—Brazil, Mexico, Argentina, or Venezuela—joint action lacks much hope of forcing bankers to provide significantly better terms and new money. [redacted]

Nonetheless, we remain concerned about the potential for mutual miscalculation to heighten the potential for conflict. We anticipate growing popular, albeit rhetorical, support for joint action in Latin America in the wake of mounting political resistance to IMF-mandated austerity. Moreover, election year rhetoric in Argentina and Venezuela probably will lead to some public clamor for collective moves to confront international bankers. [redacted]

Such criticism could cause bankers to worry about the increased risks involved in additional lending. Any heightened perception of risk could make US regional banks and smaller European and Japanese banks more reluctant to roll over loans and increase their exposures in Latin America. Should the major banks not be able to get these creditors on board or should they not be able to cover the resulting shortage of funds, one or more of the current refinancing plans could be derailed. [redacted]

Similarly, growing public criticism of IMF-mandated austerity programs could cause bankers to question the ability of Latin governments to follow through on economic adjustments. Any substantial relaxation of spending constraints by a debtor country to ease domestic unrest could then shake banker confidence, significantly slow IMF disbursements and commercial lending, and thereby cause rescue programs to unravel. [redacted] 25X1

A single collapse could set off others, ultimately triggering initiatives by one of the large debtors to seek extreme changes in the terms of its debt service and causing other debtor countries to follow suit. [redacted] Brazil, in particular, bears close watching. Should the Latin American crisis reach a critical stage, regional forums that now are discussing common financial problems could serve as negotiating blocs trying to force bankers into extending easier terms. [redacted] 25X1

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[redacted] 25X1

The Philippines: Growing Financial Strains [redacted]

25X1

As its consortium of foreign aid donors meets in Paris, Manila is attempting to avert a liquidity crisis that could force foreign debt rescheduling by late 1983. Several times during the last month, major US commercial banks have appealed to senior government officials—including President Marcos—to seek emergency commercial financing of up to $1 billion. Manila has responded by implementing financial austerity measures, but appears to be undecided on whether to privately refinance debt or hope to scrape by without the new funds. [redacted] the size of the short-term foreign debt combined with a slow contraction of short-term credit lines by private commercial banks suggests that the government has little room to maneuver. [redacted]

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Growth of the Debt

The Philippines' external finances have grown increasingly precarious since the OPEC price hikes of 1979-80. Government financial and trade data now place the total foreign debt at $18.5 billion—more than one-half higher than at the end of 1980. Our own methodology—which includes the obligations of Philippine financial institutions—places the debt at $22.7 billion, about 57 percent of GNP. [redacted]

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The current account deficit shows no sign of immediate improvement. The Philippines posted its worst balance-of-payments performance ever last year, when the current account deficit ballooned to $3.3 billion—a record 9 percent of GNP—at the same time that net direct foreign investment inflows

The Philippines: The Foreign Debt At a Glance, June 1983

Total	**$18.5 billion, excluding interbank borrowing. $22.7 billion otherwise.**
Medium- and long-term debt	$14 billion. Two-thirds owed to private banks, 40 percent at floating rates.
Term structure	Average maturity 10 years. $1.3 billion due this year, over $1.5 billion in 1984.
Interest service	$1.4 billion in 1983, over $1.5 billion next year.
Short-term debt	$4.5 billion in revolving credits and other trade financing. Commercial bank short-term debt slightly over $2 billion. Central Bank owes about $2.2 billion.
Interest service	About $700 million annually, net of Central Bank reserve asset earnings.
Central Bank liquidity	$1.6 billion in foreign exchange reserves, about two months' imports. $715 million in gold holdings. Liquidity net of short-term obligations: $173 million.
Distribution of debt	US banks: $6 billion. Largest US nine hold about $4 billion. Non-US commercial banks hold about $5 billion. US Government holds over $900 million, Japan just over $800 million, with multilateral creditors holding about $2.5 billion.
Total debt service	About $3.4 billion in 1983, or roughly 8 percent of GNP, 64 percent of merchandise exports.

[redacted]

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The Philippines: Balance of Payments *Million US $*

	1976	1977	1978	1979	1980	1981	1982 [a]	1983 [b]
Current account	**−1,101**	**−828**	**−1,172**	**−1,576**	**−2,072**	**−2,589**	**−3,347**	**−2,900**
Merchandise trade	−1,113	−840	−1,307	−1,541	−1,939	−2,667	−2,805	−2,450
Exports, f.o.b.	2,519	3,075	3,425	4,601	5,788	5,733	4,995	5,300
Of which:								
Coconut products	537	729	812	965	759	756	647	600
Sugar	451	527	213	238	474	609	324	430
Copper concentrates	270	280	250	330	679	544	340	500
Forest products	268	261	324	484	433	383	340	400
Manufactures	573	770	1,076	1,520	1,135	1,294	1,050	1,245
Imports, f.o.b.	3,632	3,915	4,732	6,142	7,727	8,400	7,800	7,750
Oil	936	1,019	1,030	1,385	2,248	2,458	2,396	2,190
Others	2,696	2,896	3,702	4,757	5,479	5,942	5,404	5,560
Services (net)	−257	−248	−178	−390	−555	−392	−992	−900
Interest payments	−258	−302	−440	−591	−846	−1,101	−1,811	−2,200
Others	1	54	262	201	291	709	819	1,300
Transfers (net)	269	260	313	355	422	470	450	450
Capital account	**1,151**	**963**	**1,082**	**997**	**1,720**	**2,029**	**2,212**	**1,950**
Of which:								
Direct investment (net)	144	216	171	99	49	407	259	300
Medium- and long-term loans (net)	1,014	859	908	1,061	1,044	1,185	1,252	1,600
Short-term [c] loans (net)	−87	−90	83	−193	446	37	423	50
Balance	50	135	−90	−579	−352	−560	−1,135	−950

[a] Estimated.
[b] Projected.
[c] Including errors and omissions.

[redacted] 25X1

dropped by one-third. Worse, to cover the gap, the Central Bank ran down reserves to $1.7 billion. This equaled about 10 percent of the foreign debt—less than half the 22-percent level at the end of 1980. [redacted] 25X1

Although Philippine balance-of-payments problems are longstanding, 1982 represents a watershed in the Philippines' external accounts. OPEC price hikes prior to 1982 swelled the oil import bill by nearly $1 billion, ballooning the trade deficit even as rising remittances from workers in the Middle East buoyed the service and transfer account. Last year, in contrast, oil imports were down in both value and volume as the recession slowed petroleum demand, domestic geothermal fields began production, and the government oil company drew down inventories. This accomplishment was more than offset as interest obligations on the foreign debt increased by $700 million. Medium- and long-term principal payments also grew by over $200 million, as the term structure of the debt shortened. [redacted]

The actual size of the short-term debt, a controversy that first arose in the international financial community early in 1982, continues to elude both the Central Bank and private analysts. International short-term claims against the Philippines rose to nearly $6.9 billion in mid-1982, according to Bank for International Settlements data—nearly twice the government's official June 1982 figure of $3.65 billion.[1] We believe that the Philippines' gross financial requirements, including repayment obligations on medium- and long-term foreign loans, renewals of outstanding short-term credits, and the trade deficit itself, reached nearly $9 billion last year, representing a $1 billion increase from 1981. When the obligations of financial institutions are included, the Philippines' gross financing requirements reached about $13 billion. [redacted]

New Liquidity Problems

Manila is currently attempting to cope with an international liquidity squeeze, while biding time until recovery in the United States improves the Philippines' external accounts. First-half 1983 balance-of-payments data show a small improvement in the current account deficit. At the same time, however, a variety of sources confirm that short-term credit lines to Philippine borrowers are increasingly restricted. Both regional and money center banks in the United States are passing up chances to renew existing credit lines or to add more Philippine obligations to their portfolios. So far, this has more than offset any improvement in the current account; the resulting need for additional Central Bank financing reached $800 million in the first half, substantially more than the government's target for the entire year. [redacted] 25X1

Press reports that internationally respected Premier and Finance Minister Virata may be replaced have contributed to private bankers' nervousness about their Philippine portfolios. In April, a ruling party caucus over which President Marcos presided attacked Virata's conduct of economic policy bitterly, charging that he had mortgaged Philippine national interests to the World Bank and the IMF, while severely depressing the domestic economy. [redacted] 25X1 [redacted] the 25X1 attack, which was fueled by pork-barrel politics 25X1 and complaints from the financially strapped business community. Virata subsequently offered his resignation—a gambit he has used in the past to force Marcos to reaffirm his support—and Marcos refused to accept it, announcing later that he would retain Virata as both Prime Minister and Finance Minister at least through the end of 1983. Nonetheless, the entire episode highlighted Virata's shaky political base, and this may have lasting and adverse effects on Manila's credit rating. [redacted] 25X1

Foreign commercial banks appear increasingly convinced that foreign debt rescheduling may be required. In May, senior representatives of several major US banks approached Central Bank Governor Jaime Laya about possible emergency financing for the rest of the year. [redacted] 25X1 25X1

[1] The BIS data include double counting errors and foreign debts covered by foreign assets, but also exclude several categories of legitimate short-term debt, such as claims against the Philippines by banks that are not members of the BIS reporting system and supplier loans. Philippine Government data, on the other hand, exclude short-term obligations by domestic financial institutions relent to the government and private firms. Much of this relending is on a medium- and long-term basis, so that the burden of rollover is borne by the domestic financial institution extending the credit. [redacted]

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The Philippines Financial Crisis: The Key Actors

Player	Significance
Central Bank of the Philippines	Charged with foreign exchange management. Also coordinates foreign borrowing program through Monetary Board. Monitors foreign debt and repayment profile through Foreign Debt Management Office.
Development Bank of the Philippines	Prominent foreign borrower. Significant relending to private sector, mostly distressed firms and state enterprises. Converting to commercial bank status, broadening domestic resource base.
Philippine National Bank	State owned commercial bank, also prominent foreign borrower. Acquiring DBP's development portfolio, but so far financially healthier. Large deposits in United States.
National Development Company	Responsible for heavy industrial development, mostly through joint ventures and foreign borrowing. Foreign borrowing operations trimmed recently.
Prime Minister Virata	Premier and Finance Minister. Widely respected by international banking community, but under fire at home politically.
The KBL caucus	Ruling party policy organ. Closely controlled by Marcos, in April vented criticism of Prime Minister Virata's austerity measures. Belatedly implemented its own in June.
Nine largest US banks	Holders of over $4 billion in Philippine obligations—most of Philippine commercial debt.
Regional US and European Banks	Hold smaller share of Philippine commercial debt. Have halted most short-term loan renewals.
Most prominent US commercial creditors	Began discussions with government officials in late June regarding up to $1 billion in emergency financing. Prefer private refinancing, but fear rescheduling necessary. Want bridge arrangement to cover all contingencies over next 18 months.
Consultative Group	Consortium of aid donors. Holding annual meeting now in Paris.
World Bank	Chairs Consultative Group, holds over $1 billion in claims on Philippines.
International Monetary Fund	Largest Philippine creditor. Recently critical of Philippine economic policy.

[redacted]

[redacted] the banks believe that Manila cannot meet its debt service obligations later in 1983 and are seeking a solution that would carry the government through 1984. Laya agreed that the banks' concerns were justified, and at his invitation the banks began discussing up to $1 billion in bridge financing in talks with government officials in Manila in late June. [redacted] 25X1 25X1

[redacted] the Central Bank is revising its own estimate of the short-term debt upwards. [redacted] short-term debt alone totals $13 billion, bringing the total to about $27 billion. Although some of the short-term liabilities of private financial institutions are covered by foreign deposits, these new data have convinced the bank that formal rescheduling later this year is a near certainty. At the urging of the banks, Manila has begun an inventory of its creditors in case rescheduling is necessary. [redacted] 25X1 25X1 25X1 25X1

Manila and the IMF

Manila recognizes it faces serious financial problems and has begun to take action. In January, the government implemented sharp cutbacks in capital spending and Prime Minister Virata announced a ceiling of $2 billion on new foreign loans for 1983 that has begun to take action. The Central Bank also curtailed the expansion of short-term debt by announcing new restrictions on foreign loan applications of less than one-year maturity. Furthermore, in a move that, according to US Embassy officials, surprised both the business community and the country's official creditors, Manila placed a 3-percent duty on most categories of imports, introduced a prepayment system of import duties designed to ensure customs collections and make import financing more expensive, and implemented a lottery system designed to channel more remittances from overseas workers through the government banking system. [redacted] 25X1

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The Philippines: Financial Flows Under Alternate Assumptions

Million US $

	1982	1983 Base Case [a]	1983 US Banker's Case [b]
The demand for funds			
Gross financing requirements	**12,969**	**12,900**	**12,900**
Medium- and long-term debt amortization	1,022	1,300	1,300
Maturing non-bank short-term debt, errors, and omissions	4,500	4,500	4,500
Maturing short-term debt, financial institutions	4,100	4,200	4,200
Current account deficit	3,347	2,900	2,900
The supply of funds			
Official financing	**700**	**800**	**800**
Project loans [c]	0	170	170
IMF compensatory financing	0	340	340
IMF standby financing	259	300	300
Foreign investment			
Commercial bank financing	**10,910**	**10,340**	**10,040**
Rollovers [d]	8,000	6,250	5,500
Net new loans [d]	2,860	2,990	3,140
Exceptional financing			
Debt rescheduling (principal) [e]	50	100	800
Bridge loans	0	1,000	600
Reserve drawdowns	**1,100**	**950**	**1,250**

[a] Base case—rollover of short-term credits, successful bridge financing.
[b] US bankers' case—continued contraction of short-term credit lines.
[c] Includes World Bank Structural Adjustment Program.
[d] All maturities.
[e] Private sector only in 1982 and base case 1983. Public and private sector, US bankers' case 1983.

[redacted]

Manila also reached agreement with official creditors about its economic policies, ending a confrontation that delayed official balance-of-payments support during 1982. The government obtained a 12-month $347 million IMF standby loan in February, a $170 million credit from the Fund's Compensatory Financing Facility to replace the shortfall in export earnings, and a $300 million Structural Adjustment Loan from the World Bank. The Fund's program requires limits on foreign borrowing, domestic credit creation, and Central Bank credit to the public sector. [redacted] 25X1

The World Bank and IMF, however, have left Manila no margin for error in trimming the current account deficit by requiring that it implement appropriate adjustment policies. The World Bank loan required reform of energy pricing, further liberalization of trade policy, and a long-promised streamlining of foreign investment regulations. Disbursement of most of the IMF loan was held in abeyance pending a comprehensive June review of Philippine budgetary performance, exchange rate management, interest rate policy, external borrowing activity, and efforts to curtail the growth of the short-term debt. [redacted] 25X1

US Embassy reporting indicates that, when the review was completed last week, the Fund expressed unhappiness with Manila's slow response to its balance-of-payments problems. It appears, however, that the Fund will disburse the remainder of the standby credit rather than risk provoking a crisis of confidence among Manila's private creditors. In any case, in late June President Marcos announced austerity measures formerly promised to the Fund and the Bank. Manila devalued the peso by 8 percent, indefinitely suspended several

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major industrial projects, removed domestic oil price subsidies, and announced a thorough review of foreign borrowing. [redacted]

The Near-Term Outlook

The annual meeting of the Philippine Consultative Group this week in Paris—Manila's consortium of aid donors chaired by the World Bank—will provide a forum for the Philippines' international creditors to examine the country's prospects. The meeting will feature an unprecedented "third day" for the international commercial banking community to participate and will thus provide a unique opportunity for all of Manila's creditors to examine the proposed adjustment program. For its part, the Central Bank will almost certainly regard the special sessions as an opportunity to assuage the bankers' fears about the government's ability to repay its debts. [redacted]

We believe the Philippines' financial problems will be only slightly eased by international economic recovery this year. Philippine Government agencies and the US Embassy calculate on the basis of studies of previous business cycles that six months will be required for the benefits of economic recovery in industrial economies to be felt in the Philippines through higher prices for industrial raw materials and agricultural products. Even the Philippine commercial press reports that most businessmen have already written off 1983. [redacted]

Manila may decide on a voluntary refinancing of the short-term debt. If it adopts this course of action—which we believe would be held in abeyance until Virata returns to Manila in mid-July—the Philippines' medium- and long-term debt service would rise substantially. Manila's own laws that limit medium- and long-term debt service to 20 percent of the previous year's foreign exchange earnings would then have to be modified, and the dimensions of Manila's financial problems would become public knowledge. [redacted]

The actions of the international banking community itself, however, will determine whether formal debt rescheduling is necessary. Of greatest potential short-run consequence is the increasing trend among small US and European banks to refuse to roll over existing short-term credit obligations. [redacted] the largest US banks, which hold about 40 percent of the Philippine external commercial debt, are aware of this problem and increasingly concerned by it. Indeed, several money center banks have begun to withdraw from the Philippine market. [redacted]

The size of the short-term debt makes bank reluctance to roll over debt by far the most serious problem. We believe that the exposure of the small US and European banks is sufficiently small that the Central Bank could continue drawing down reserves to prevent a foreign exchange crisis, but only if money center banks roll over their remaining short-term credit lines. This course, however, would leave the Central Bank with very low reserves in late 1983. The late June devaluation of the peso may ease the pressure on reserves substantially, but further devaluations will be necessary if credit lines shrink. Manila's outstanding short-term liability of over $1.2 billion in bankers' acceptances is especially vulnerable and would provide advance warning of further liquidity problems. [redacted]

[redacted] the Central Bank's official reserve figure overstates liquidity because it includes about $1.3 billion in time deposits that are tied to credit lines as compensating balances. [redacted] the Bank will face liquidity problems between July and October, when foreign exchange receipts are traditionally slow. We believe, however, that the Central Bank may still have some breathing room because of about $450 million in undrawn credit lines which the government has been reluctant to utilize. Draw-

25X1 25X1 25X1 25X1 25X1 25X1 25X1 25X1 25X1 25X1 25X1 downs of these credits would thus also provide advance warning of impending liquidity problems. [redacted]

A Difficult Road Ahead

Over the longer term, all of the measures required to stabilize the balance of payments carry a potentially heavy political price. Reducing government financial support to the private sector as a means of reducing the budget deficit will produce new corporate bankruptcies and, coupled with reduced investment in state enterprises, higher unemployment.[2] Additional breathing room would be created if Manila took even stronger measures to trim the trade deficit. Suitable exchange rate depreciation during the next two years will be a critical step to capitalize on any upturn in industrialized economies beyond 1983. [redacted]

[2] About three-fourths of the medium- and long-term debt is now either public or publicly guaranteed, versus one-half several years ago. This reflects the extent to which private foreign liabilities recently have become public obligations as a result of government bailouts. [redacted]

Even if it scrapes by in 1983 and 1984, Manila still faces the task of restructuring the economy, thereby alleviating fundamental balance-of-payments problems attributable to an uncompetitive manufacturing sector and the changes in international petroleum, sugar, and coconut oil components of the terms of trade. The Philippines' official creditors recognized the need for this in 1979 when the IMF negotiated the first of a series of credits intended to facilitate Manila's gradual adjustment to higher oil prices, and the World Bank committed up to $800 million over five years in the form of a "structural adjustment" program, which requires reform of industrial policies and the development of labor-intensive export manufacturing. [redacted]

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